

# THE PIPEs REPORT

NEWS, INFORMATION, AND ANALYSIS OF PRIVATE INVESTMENTS IN PUBLIC EQUITY

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## AGUIRRE: PIPE INVESTORS MORE HEAVILY REGULATED THAN OTHER HEDGE FUNDS

by Max Frumes

Fired and recently vindicated, former Securities and Exchange Commission investigator Gary Aguirre explained to *TPR* why he feels the SEC fell short in its investigation of one of the world's largest hedge funds. What's more, he warned that hedge fund regulation, even with Senate intervention and current talk about change at the SEC, will continue to be ineffective unless there is change in the big-business-catering culture of the SEC.

Aguirre's case has divided and tormented the SEC since he was fired back in September 2005. Aguirre claimed that his superiors at the SEC stymied his investigation into **Pequot Capital Management** because of their fear of former Pequot chairman and current **Morgan Stanley** CEO John Mack's political clout. The Pequot investigation was eventually closed without prosecution despite evidence of insider trading.

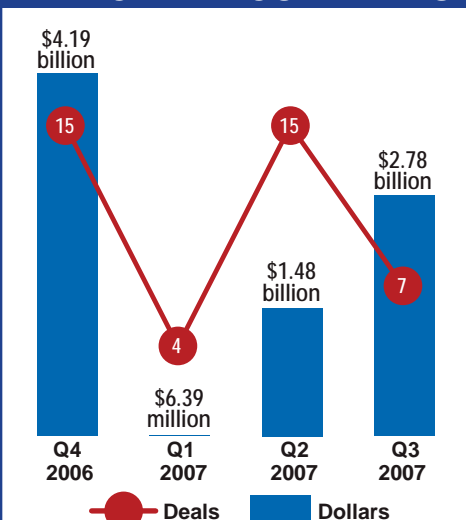
The top SEC enforcement official Linda

Thomsen refuted Aguirre's claims in congressional testimony. But Aguirre's letters to Congress and his own testimony attracted media attention and prompted investigations by the Senate's judiciary and finance committees. The committees' 105-page report largely supported Aguirre's claims.

Aguirre first detailed his case in a letter to Sen. Chuck Hagel in May 2006. It said that the SEC had filed three cases of insider trading relating to PIPE transactions against hedge funds and was investigating 24 others. These were the majority of insider trading cases involving hedge funds. Only three other non-PIPE-related suits of the same nature had ever been filed. Aguirre suggested that because insider trading in PIPEs is easy to detect, the SEC has an easier target. But in prosecuting only the PIPEs perpetrators, the SEC is ignoring a larger pattern, he wrote.

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## PIPEs ISSUED BY LENDING AND CREDIT COMPANIES



Source: PrivateRaise

## TREND

Watch

## FINDING RELIEF IN PIPES

Mortgage Providers Enter the Market

by Joe Gose

Over the last couple of years, PIPE market players have repeatedly pointed to the growing acceptance of private-placement financing among large and small companies in mainstream industries as a sign of the market's evolution.

The credit market spasm, which has catapulted many financial companies into distress, is providing further evidence.

A handful of mortgage providers with market capitalizations ranging from \$90 million to \$11 billion have tapped the PIPE market since early July to raise more than \$2.3 billion in emergency financing, according to PrivateRaise, which tracks placements of more than \$1 million. These are the first PIPEs for many of these issuers, which in the past have raised capital through secondary offerings, shelf offerings or credit facilities.

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Indeed, the SEC's most recent suit against a hedge fund manager follows this pattern of cracking down on illegal trading activity perpetrated via PIPEs, while no similar non-PIPE cases have been filed recently. On Sept. 13, the SEC filed a civil suit in the District Court of Eastern Pennsylvania alleging that Robert A. Berlacher bought into PIPEs on behalf of nine hedge funds he managed or advised, sold the stock short and then illegally covered the short positions with PIPE shares, which were purchased at a discount.

The total investment in the PIPE market so far this year is \$34.12 billion. In only eight months, this exceeds any previous year on record, according to PrivateRaise, which has tracked PIPEs of \$1 million or more since 2001. The mergers and acquisitions market so far this year totals \$1.98 trillion, according to data from Capital IQ.

Evidence suggests there could be insider trading going on in 40% of the largest mergers and acquisitions. According to a study commissioned by the *New York Times* from Toronto-based research firm Measuredmarkets Inc., 37 out of the 90 mergers with a value of \$1 billion or more within a 12-month period exhibited abnormal and suspicious trading.

### Aguirre on Hedge Fund Regulation

Hedge funds currently control \$2.6 trillion of the more heavily traded securities in the stock market, and Congress is certainly cognizant of the potential influence, given recent high-profile implosions: On July 11, The House Financial Services Committee convened representatives of the Federal Reserve Board, the U.S. Treasury Dept., the SEC, and the Commodity Futures Trading Commission to examine how the Bush Administration was monitoring hedge fund activity in the securities markets.

In closing, Financial Services Commit-

tee Chairman Barney Frank commented that there was an agreement that things weren't entirely right, but that there wasn't anything obvious to do differently. He said that the investors being hurt by collapses of funds such as **Amaranth** seemed mainly to be rich investors who are presumed able to absorb the losses.

In the middle of rearranging his life, moving to Southern California and appealing his termination with the federal Merit Systems Protection Board, Aguirre spoke with *TPR*. He said that Frank's reasoning ignores a larger risk to the market.

"I think that it's very easy for the Senate Banking Committee and the House Financial Services Committee to adopt the mantra, 'Hedge fund fraud only hurts the wealthy and they can take care of themselves,'" said Aguirre. "I don't disagree with the premise that wealthy investors can take care of themselves. But that's not the risk that Congress ought to be worried about. The major risk that hedge funds pose is to other market players: those who work against the tilt, sellers who don't get merger tips, buyers who don't get earnings tips, mutual fund investors who get their pockets picked.

"And then there are the multiple layers of leverage: investment banks, themselves leveraged, make highly leveraged loans to hedge funds. Funds of funds add yet another level of leverage. It's all cumulative," he said. "That leverage plus the market games of the 1920s, which undermined investor confidence, combined to give us the 1929 crash," said Aguirre, who studied this subject when he received his master's degree in law at Georgetown University.

Regulators currently rely on something called counterparty discipline to control hedge funds, according to Aguirre. The theory behind counterparty discipline is that big institutions such as investment banks, which operate in the capital markets independently of hedge

funds, will serve to keep the hedge funds in check. Aguirre said that that discipline is unreliable because those institutions are influenced by the same market forces as the very funds they're supposed to check.

"So counterparty discipline in my judgment is a myth, which flips reality upside down. It's a palliative, it's a salve. And it's been sold to the regulators and people like [Federal Reserve Bank Chairman] Bernanke, who have never been down in the trenches," he said.

### Political Divide

Aguirre said the SEC has not effectively regulated hedge funds in part because of the divide between the SEC's political appointees and its rank-and-file staff. This friction is partly what puts the SEC under the sway of big business, he said.

"There is and has been [such a divide] for some time. There were folks on the commission, for example, former Chairman Donaldson, that felt the SEC really ought to be carrying out its mission, and then there are others that have a different perspective on what the SEC ought to be doing," he said. "There's always been sensitivity at the leadership level of the SEC not to run afoul of the Wall Street elite, simply because they have the power and they may be your next employer."

In the time since the Pequot investigation, there has been an exodus of senior SEC officials involved in the case. The day the Senate report came out, SEC Inspector General Walter Stachnik resigned. The Senate report had described Stachnik's office's lack of investigative curiosity in Aguirre's case as "disturbing." In customary fashion, the SEC issued no press release on the head official's departure. An SEC representative told *TPR* that Stachnik had been planning to leave for years. Stachnik became the first inspector general at the SEC in 1989.

According to the Senate Report, Paul Berger, a supervisor of Aguirre's in the

enforcement division, left the SEC in May 2006. At the SEC, Berger had prevented Aguirre from deposing Mack. After leaving the SEC, Berger joined the law firm of **Debevoise & Plimpton**. During the Pequot investigation, Debevoise had contacted the SEC about John Mack on behalf of Morgan Stanley's board of directors.

Three senior SEC officials sided with Aguirre on the subject of taking Mack's testimony. At least two have retired: Hilton Foster retired after 30 years at the SEC just before Aguirre was fired, shortly followed by Joseph Cella. The third, branch chief Eric Ribelin, asked to be removed from the investigation – the first such request by him in at least 14 years at the SEC, according to the Senate report.

### Mack, Pequot and the Lawyers

The Senate report highlights possible evidence of insider trading involving Pequot. In one instance, the report described how Pequot invested in **Microsoft** using information provided by Microsoft employee David Zilkha, who subsequently went to work for Pequot. E-mails show how Pequot CEO Art Samberg contacted Zilkha at Microsoft. Zilkha then provided Samberg with a tip that Microsoft's "CFO has been more relaxed before this next earnings release than he has been in the last year." Microsoft later released earnings that topped expectations. Samberg made a quick \$1.6 million profit, the report says.

Despite such examples, the investigation was closed without prosecution.

Though there was no evidence that Mack had a hand in preventing or delaying his testimony, there was evidence that Morgan Stanley lawyers may have. Former U.S. Attorney Mary Jo White, now a partner with Debevoise & Plimpton, contacted enforcement chief Thomsen directly on behalf of Morgan Stanley. Another Morgan Stanley representative contacted Berger, according to the report. Soon after, "SEC man-

agers prohibited the staff from asking John Mack about his communications with Arthur Samberg at Pequot," the report states.

Debevoise reportedly said that it never suggested the investigation be stopped.

The report also mentions Audrey Strauss, a lawyer from **Fried, Frank, Harris, Shriver & Jacobson** representing Pequot. It said she met with Stephen M. Cutler, then director of enforcement at the SEC. Two weeks after the meeting, the report said, the investigation into Pequot was narrowed. "The staff was ordered to investigate only a few of the suspicious transactions" flagged by the New York Stock Exchange, the report said.

After the report came out Strauss sent a letter to Sens. Max Baucus, Charles Grassley, and Arlen Specter on Aug. 6 to "set the record straight." She wrote that she did not meet with Cutler about the Pequot investigation in early 2005, nor did she ever discuss the Pequot investigation.

*TPR* asked Strauss if any representative of Fried Frank encouraged anyone at the SEC to narrow the investigation of Pequot. Pequot spokesman Jonathan Gasthalter, who replied for Strauss, said that "it would be inappropriate to comment on our legal strategy."

Mack was being courted by Morgan Stanley and **Credit Suisse First Boston** about two weeks before the public announcement of **General Electric's** acquisition of **Heller Financial**, which both Morgan and Credit Suisse were working on. Pequot made \$18 million profit in 30 days by purchasing Heller stock and shorting GE right before the acquisition was publicly disclosed. Around the same time, Mack more than tripled a \$5 million personal investment through Pequot, according to Aguirre's report. The Senate report says that this should have been more fully investigated.

Though Mack eventually testified after

Aguirre was fired, his testimony came five days after the statute of limitations expired.

The Senate report concluded that by "allowing the perception that 'going over the head' of SEC staff attorneys yields results, the SEC undermines public confidence, the integrity of its investigations and exacerbates the problems associated with 'regulatory capture'."

*TPR* contacted Morgan Stanley to ask about the Senate report's and Aguirre's inference that Mack had traded insider information with Samberg for an investment in Pequot.

Morgan Stanley spokeswoman Jean Marie McFadden referred *TPR* to pages of the Senate report that show that Mack himself never dissuaded the SEC from pursuing the investigation, and that the conclusion of the Pequot case exonerated Mack.

### False Progress?

The SEC has ostensibly taken steps towards further regulating hedge funds and has said it will do more. Thomsen recently stated that the SEC has made investigating insider trading ahead of mergers and acquisition one of its top priorities. The SEC approved an antifraud rule to expand the definition of fraud in hedge fund cases.

In a recent webinar sponsored by *TPR*, Kevin Carreno said that the SEC is not done with its attempts to regulate hedge funds and pooled investments. Carreno is a hedge fund adviser with The Experts Counsel.

Carreno said that the SEC is going to apply anti-fraud provisions to any investment adviser, presumably even if they are exempt from registration. The commission is also going to find ways to further restrict the entry of "retail" customers into hedge funds.

Carreno said he would advise hedge funds to consider adopting some disclosure and reporting practices.

# FEATURE STORY

## Aguirre

"I do believe we're going to end up with Congress imposing some regulatory scheme on hedge funds," he said. "Rather than waiting to react to whatever Congress is going to impose, I would certainly suggest or recommend that hedge funds look at how they can bring themselves within one of the registration criteria."

Carreno said that the new antifraud rule passed by the SEC will bring little change. It was probably intended, he said, to head off a legal argument that federal securities laws somehow don't apply to unregistered advisers.

"Everyone, if you engage in some type of fraudulent scheme and the qualifying criteria is that it occurs in interstate commerce – then you're covered by all of the antifraud provisions of the federal securities law," he said.

### Rehabilitating the SEC

Aguirre suggested signs to look for that the SEC is really changing its culture.

"Several things might give a clue whether Chairman Christopher Cox and the SEC are serious about changing its culture," he said. "Chairman Cox could appoint a no-nonsense inspector general. So that if there's any of these Berger type deals – someone closing down an investigation that should not have been stopped and then firing the head investigator – they can expect a serious I.G. investigation, not a whitewash."

To go forward, Aguirre looks back. The 1933 and 1934 securities acts were all about disclosure, he says. There's little hope of completely containing runaway speculation or the jungle in which small investors find themselves when they're trading on the markets, according to Agu-

irre. But why not take a baby step: have hedge funds make periodic disclosures.

"The SEC under Chairman Donaldson was trying to go there, but they got blown out by the Goldstein case," Aguirre said, referring to the lawsuit filed by hedge fund manager Phillip Goldstein, that prevented mandatory registration of hedge funds. "The President's Working Group also recommended periodic disclosure for hedge funds after Long-Term Capital failed. But investment banks were able to scuttle that recommendation.

"At a minimum, hedge funds ought to be registered as investment advisers. That would require them to make quarterly disclosures, maintain certain records, and make their records available to the SEC when there is a crisis," said Aguirre.

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